SEARCHING FOR NORMAL

The Federal Reserve and Investors Share the Same Goal

By Craig Bishop and Tom Garretson, CFA®
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The U.S. Federal Reserve (the Fed), much like the late queen of soul Aretha Franklin, often seems to be clamoring for a little respect. It’s not been enough for it to have rescued the U.S. economy from the clutches of the Great Recession, or to have assumed the mantle of the world’s central bank in helping to stabilize global economies. Depending on the moment, policymakers have been criticized for moving too slow or too fast in their response to economic data in implementing monetary policy. Market observers, investors, politicians, etc., demand policy normalization without really understanding what the term means.

In our view, despite the recent mounting political pressure, and against what many deemed to be low odds of success, the Fed very well could be on the cusp of engineering its equivalent of nirvana—a soft landing. This presents investors with challenges, but we suggest they are better served to set aside their search for “normal” and take advantage of opportunities presented by current market conditions.

RECOVERIES DON’T DIE OF OLD AGE

There has been enough coverage of the Fed’s extraordinary measures to counter the impact of the Great Recession. Suffice to say, its seven-year-long zero interest-rate policy combined with several iterations of quantitative easing were what was needed to jump-start growth. And just as a prudent central bank should, it realized when it was time, in December 2015, to begin methodically removing the “punch bowl” of monetary policy stimulus so as to moderate growth and prevent the economy from overheating. The success of the Fed’s actions can be seen in the current economic recovery, which in July 2019 has just taken the title as the longest on record.

Prolonged winning streaks in anything ultimately increase the predictions of their demise, the current economy notwithstanding. Often these are based solely on the passage of time. Our opinion is that economic expansions don’t simply die of old age. An economy will move through several stages during its life cycle, and although it’s true the current expansion is long in the tooth and exhibiting some late-cycle characteristics, “late in the cycle” doesn’t necessarily mean “end of the cycle,” in our opinion.

“Late cycle” is a term heard frequently these days, as well as the fact that over the past 10 years economic growth has been far from robust, averaging just 2.2 percent—well below the 3.3-percent long-term average. However, nothing indicates that the end of the economy’s winning streak is imminent. Late cycle carries a negative connotation, suggesting a recession is approaching, bringing with it potentially dire consequences for investors. In retrospect, though, this long period of slow growth may have been just what was needed to unwind the unsustainable imbalances of the Great Recession.
In our view, a sole focus on the time elapsed for this expansion is misdirected. And based on the key indicators we monitor, the current cycle likely has room to run, with Fed policy playing a critical role.

CHECK THE SCORECARD: SLOWDOWN, BUT NO RECESSION
The timing of a recession ultimately depends on the direction provided by the economic data; even so, it can still be a difficult call. Analysts have been making late-cycle calls for at least two years, even though the “late” stage in the economic cycle has a typical lifespan of approximately 18 months. And to further muddy the waters in recent months, there has been some fluidity to economic indicators as they move between mid-, late-, and end-of-cycle stages.

Our scorecard of a half-dozen forward-looking economic indicators, shown in Table 1, gives near unanimous readings—only the yield curve is flashing caution—consistent with the economic expansion having further to run. So even though mid-, late-, and end-of-cycle indicators are elevated, we believe recession risks remain low for now. This is notable because recessions always have been associated with equity bear markets and a challenging time for some parts of the fixed income market.

In all of the recession talk, many investors’ and the media’s point of reference is the Great Recession, which to us is misplaced because of the extraordinary impact of this particular event. It is important to remember that recession is just another word for periods of economic distress and contraction, which are common to most economic cycles. They are typically short, lasting nine to 18 months, and the National Bureau of Economic Research (NBER) is, among other things, called on to identify when recessions begin and end. Its recession scorecard focuses on five economic indicators: real gross domestic product, income, employment, manufacturing, and retail sales. To the NBER, a lengthy (six-month) decline in these indicators represents a recession. So within the current expansion, some of these indicators have begun to show signs of deterioration. However, as we’ve previously noted, late cycle is not synonymous with end of cycle, and we believe the next recession is not imminent.

GLOBAL HEADWINDS?
The current global environment, which features geopolitical concerns, fast-changing trade disputes, the imposition of tariffs, and uneven growth across various regions, poses a number of challenges for the global economy.

The question, from our perspective, is not so much whether any one or all of these would cause the U.S. economy to dip into a recession, but whether they might accelerate the economy’s advancement through its life cycle. So far, the answer has been no. The U.S. economy continues to display a high degree of resiliency, with economic performance unaffected by events in China in late 2015, Brexit in 2016, and most recently the uncertainty from the administration trade/tariff policies. It is likely the U.S. economy will be able to withstand the challenges posed by trade disputes, but these could, depending on their duration, push the U.S. economic data more decisively into the late-cycle column.

FED POLICY PIVOTS TOWARD STABILITY
As this recovery has migrated through the various stages of the economic cycle, we’ve seen the Fed adjust monetary policy to fit the prevailing circumstances. But it hasn’t always been smooth sailing. A case in point is how monetary policy has changed since December 2018. The Fed raised rates and projected additional rate hikes in 2019 and 2020. Markets reacted negatively to the Fed’s policy tone-deafness and inability to see that the cumulative impact of rate hikes was having the desired effect of moderating economic growth and keeping a lid on inflation.

Fast forward a few months and policymakers have taken all 2019–2020 rate hikes off the table, leaving one in 2021. Furthermore, by signaling they are poised to cut rates in coming months they have proven once again that pauses in policy are only temporary. In 2006 then–Fed Chair Ben Bernanke signaled a policy pause after a June rate hike and the next policy action was a rate cut in September 2007. The market is predicting that the Fed will cut rates three times by the end of 2019 (see Figure 1).
Our views align with market expectations and we go one step further to suggest the Fed policy is on the verge of engineering an economic soft landing, something not seen since the late 1990s. If this pans out, the period ahead likely will be characterized by easier Fed policy, flat yield curves, and relatively low interest rates. These somewhat uncharted waters, though, complicate matters for investors in their continuous search for a normal investment environment, but we have some advice to help them navigate through the uncertainty.

**THERE’S NO SUCH THING AS NORMAL—STOP INVESTING LIKE IT**

The idea that there exists a normal state with respect to interest rates, or central bank policy, or any number of things, may do more harm than good when investing. Accepting that there is no such thing as normal may even help to drive better investment decisions.

The idea of “normalization” has been a constant theme for investors since the financial crisis of 2008. The market impact and the steps taken in response—particularly by global central banks—were so extreme that there now seems to exist in the psyche of investors some form of pre-crisis normalcy that we’re all trying to get back to.

But what even is normal? The Fed has been leading the charge in this respect, and it regularly has used that verbiage when talking about “normalizing” the balance sheet and raising short-term rates to “more normal” levels (see figure 2).

According to that school of thought, interest rates were well below historical norms, so there was no reason yet to fear the Fed. But in December 2018 that all changed as U.S. equity markets neared bear market territory following the Fed’s decision to raise short-term rates to just 2.50 percent, with fears only heightened that the Fed might even push rates beyond that.

For fixed income investors, this idea of normal likely has had even more of a direct impact on investment decisions, and often leads, in our view, to poor choices.

Perhaps it’s just human nature to look to the past as the correct representation of what’s normal. For example, another oft-cited case—and complaint—is that U.S. economic growth during this cycle has been slower than it was during most past economic expansions. Although this is true, few acknowledge that historical growth was abnormal, and the type of growth we’ve seen more recently is closer to normal.

For equity investors, this framework of thinking regularly has been featured in headlines as justification to take comfort.

**THE LONG AND THE SHORT OF IT**

Investing in fixed income in a rising interest-rate environment is always tricky, perhaps even more so when starting from 0-percent interest rates. The natural inclination is to find safety in the front end of the curve where there’s little interest-rate risk.

But as figure 3 shows, this has been a losing strategy since the Fed started raising rates in December 2015. The Bloomberg Barclays US Aggregate Bond Index comprises most major fixed income sub-asset classes. Had you invested only in 1-3-year maturities from the day the Fed first raised rates on December 16, 2015, your total return would have been just 4.2 percent. However, the long end of the curve, beyond 10 years and supposedly posing greater risk in a rising-rate

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**WHAT EVEN IS NORMAL?**

The 10-Year Treasury Yield since 1964

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environment, has posted a total return of 15 percent.

As figure 3 shows, there’s more volatility in long-dated securities, but for buy-and-hold fixed income investors, that should be of little concern. Barring defaults, you know where your bond is going to end up.

GET OUT OF YOUR COMFORT ZONE

We have long advocated the “lower for longer” mantra with respect to rates this cycle, and to not be afraid of extending on the yield curve. That story was relatively easy to sell five years ago when short-term securities paid almost nothing, and yield curves were steep everywhere. But now that short-term instruments have yields nearing 2.30 percent as in the case of certificates of deposit, and with the flattening or inverting of the Treasury yield curve dominating headlines, investors are asking why they should, or even need to, buy longer-dated securities when similar levels of yield can be found in short-dated ones.

There’s a reason it’s called “reinvestment risk” and not “reinvestment opportunuity,” though many investors hope to reinvest at higher rates and steeper yield curves. But the point remains that there is risk in focusing only on short-term maturities, particularly because the market is still pricing a greater chance of a rate cut in one year than it is for a rate hike.

There may not be much incremental yield found in moving out on the curve, but investors are locking in that yield for longer (see figure 4). And as we maintain our observation that the Fed is likely poised to begin cutting interest rates soon, we think that’s reason enough to not ignore the long end of yield curves. Like nearly all cycles that have come before, the next phase of yield-curve steepening likely will be driven by falling yields at the front end, not rising yields at the long end.

Though yields remain historically low, that doesn’t mean they are abnormal—our take is that there is no such thing as normal. Thinking that there is could cause investors to leave money on the table, especially as “late-cycle” indicators show that a continuation of slow and steady growth is more likely than an imminent recession. Therefore, in our view, we believe it is too early to become aggressively defensive with respect to either equities or fixed income.

Craig Bishop has more than 30 years of professional experience in the financial services industry which includes experience in sales, trading, and marketing/portfolio analysis of all fixed income products. He is a member of the Global Portfolio Advisory Committee and the U.S. Investment Committee. He earned a BS in finance with a minor in economics from Illinois State University. Contact him at craig.bishop@rbc.com.

Tom Garretson, CFA®, chairs RBC Wealth Management’s Active Allocation Portfolio and serves as a member of the Global Portfolio Advisory Committee and the U.S. Investment Committee, with the responsibility for setting firm-wide asset allocation recommendations. He earned a BS in finance from the University of Denver and an MBA from the University of Minnesota’s Carlson School of Management. Contact him at tom.garretson@rbc.com.